Constitutionally required, that cable operators be allowed to recover their acquisition costs as they make the transition into rate regulation. As expected, certain Telco Commenters urge the Commission to prohibit cable operators from including their excess acquisition costs (above original costs) in their rate base. In support of their argument, the Telco Commenters argue that cable operators are not entitled to recover from subscribers excess acquisition costs because they represent an expectation of monopoly profits. However, these Telco Commenters conveniently overlook numerous factors that dictate the recovery of full acquisition costs.

The Telco Commenters fail to recognize that the price paid for cable systems was reached in either a regulated or competitive environment where there could have been no expectation of monopoly profits. Acquisitions that occurred before 1984 or after 1992 took, or will take, place in either a regulated or a competitive environment in which the purchaser could have no expectation of future monopoly profits. Acquisitions that occurred during the interim eight-year period occurred in a competitive marketplace where numerous buyers bid on a given system and the seller and eventual buyer arrived at a purchase price based on arm's length negotiations. In both situations, the purchaser paid a price based on the market conditions at the time the system was sold. In this situation, no cable operator in acquiring a cable system at prevailing market prices, could have been expected to anticipate the system would become subject to rate regulation, or that its acquisition costs would be disallowed to the extent they exceeded the undepreciated original cost of the system. This is particularly true where the acquisition of the cable system was subject to the regulatory approval by local authorities. If local authorities previously approved these acquisitions, it would seem disingenuous for the Commission or local franchising authority to conclude at a later date that these previous acquisition somehow were tainted.

The Telco Commenters also fail to recognize that if anyone benefited from any premium paid for the system it was the persons who sold them, not the persons who purchased and currently operate them. The persons who purchased systems did not benefit in any way by paying "premium" prices for the systems. Most of these cable operators had to acquire their systems through some form of debt financing and make monthly payments on that debt service for which they remain responsible. As the Massachusetts Community Antenna Television Commission pointed out in its Comments, these cable systems "face financial pressure that impacts the operation of their system, or the rates that they pay, because of their high amounts of outstanding debt." It is important to remember that cable operators' financial obligations resulting from their purchase of their systems, which occurred in an unregulated environment, will continue to exist notwithstanding the onset of rate regulation and that they remain responsible for these financial obligations. If cable operators are denied the right to recover their full acquisition costs, they will not receive the revenue necessary to cover their existing obligations.

Finally, the Telco Commenters fail to recognize the importance of a transition mechanism to assist cable operators as they enter regulation. Many regulatory agencies have adopted transition mechanisms for industries that make the jump from an unregulated to a regulated environment. See, e.g., Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Docket No. RM87-34-065, Order No. 636, Section XI (FERC, April 8, 1992); 1991 Rate Base Decision, 7 FCC Rcd 296 (1991).

In view of the fundamental shift in regulatory policy governing the cable industry, it is essential that the Commission allow cable operators to recover the investment they made prior to rate regulation. The prices for which cable systems sold reflect the economic reality that sellers typically have had to recover their deferred costs as well as their deferred profits at the time of sale. In many cases, the only way that cable operators have been able to make any return on their investment has been to sell their systems. With the onset of rate regulation, it has become unclear whether cable operators will be able to recover their deferred costs, as well as their deferred profits, on the sale of their systems at a future date. Because cable operators may be unable to recover any excess acquisition premiums when they sell their systems: the Commission must allow them to include their full acquisition costs in their rate base as a transition mechanism.

V. On A Going Forward Basis Cable Operators Must Be Permitted To Include In Their Rate Base At Least A Portion Of Their Acquisition Cost To Justify Current Rates Or Rate Increases.

It is essential that cable operators be able to use cost-of-service as more than a transitional mechanism into rate regulation. Cost-of-service is not a "one-time" thing but is a mechanism cable operators must be able to use on a going forward basis. Cable operators <u>in regulation</u> must be permitted to use cost-of-service to justify current rates or rate increases, just as cable operators <u>entering rate</u> regulation can use cost-of-service to justify existing rates. Cable operators must have a mechanism to recover the investment they make in the systems they acquire whether they are just entering, or already subject to, rate regulation. In either event, the cable operator has made an investment in a system to which it ultimately is entitled to recover.

There are strong arguments that cable operators should be able to include in their rate base their full acquisition cost. 20/ To ensure the future financial stability of the cable industry and as a matter of fundamental fairness, we suggested in our Comments that to justify either current rates or rate increases, cable operators be permitted to include in their rate base, at a minimum, that portion of their acquisition cost that would be required to reproduce the cable system (less depreciation reflecting the system's age), plus the deferred costs that would be incurred by the cable operator in launching service. This amount represents the bare minimum a person would have to pay to construct and develop a cable system and, accordingly, the minimum portion of the acquisition price that any cable operator should be permitted to recover. Anyone entering the cable business would have to raise capital equal to at least the construction (reproduction) cost of the cable system, plus enough to cover all losses that would be incurred during the start-up phase of the system until it reaches profitability. In our Comments, we also urged the Commission to allow cable operators to make an additional acquisition adjustment in the event they can demonstrate their acquisition resulted in

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20/ Indeed, numerous courts and regulatory authorities have allowed regulated entities to include their full acquisition costs in their rate base particularly where the sale and purchase of the property was conducted at arm's length and benefited consumers. See Re Peoples Gas Systems, Inc., 119 PUR4th 252 (1990); Re Northeast Utilities Public Service Co. of New Hampshire, 114 PUR4th 385 (1990); Re Interstate Power Co., 81 PUR4th 471 (Iowa PSC 1987); Re Indianapolis Water Co., 75 PUR4th 643 (Ind. PSC. 1986).

operating efficiencies. Under these circumstances, cable operators would also be permitted to include in their rate base that portion of their acquisition costs that generated a return to the cable operator equivalent to any operating expenses its subscribers saved through the efficiencies resulting from the acquisition.

VI. There Is A Realization That Small Systems Deserve Special Consideration.

In our Comments, we proposed various way to reduce unnecessary burdens on small systems. First, we urged the Commission to permit small systems to rely on a simplified "net income" analysis as a transitional mechanism by which systems with less than 1,000 subscribers would be deemed to have reasonable rates if their net income margin is less than 15.5 percent. Next, we urged Commission to adopt a streamlined cost-of service model for small systems with fewer expense categories. Finally, we urged the Commission to allow small systems to use whatever consolidated accounting methods they had as of April 1, 1993. Because small system operators maintain their accounting records on a consolidated basis for groups of systems for the purposes of efficiency, it would be an unnecessary burden for small systems to have to allocate costs and revenues to derive figures for a franchise-level or system-level cost-of-service showing.

The vast majority of commenters offered no objection to reducing the administrative burdens and cost of compliance for small systems. A handful of Telco Commenters (such as NATOA, BellSouth, and the counties of Austin, Texas, King County, Washington, and Montgomery County, Maryland) suggest the Commission not treat small system operators any differently than large systems operators. These

Commenters argue that the benchmark/price cap regime provides small systems with an option that has few administrative burdens. They also argue that the benchmarks already benefit small operators by giving them higher rates per channel than are available to operators of larger systems and, in some cases, small systems operators earn "high" rates of return. See Comments of NATOA, at p. 17; Comments of BellSouth, at p. 32; and Comments of Various Counties, at pp. 14-15. These Commenters fail to recognize that small systems incur many of the same fixed costs as large systems but have fewer subscribers over whom to spread their fixed costs. These Commenters also fail to recognize that small systems have fewer resources (both financially and personnel) to devote to cost-of-service analysis and, accordingly, the burden of preparing any analysis is much heavier for smaller systems.

Congress understood the special status of small systems in mandating that the Commission design rate regulations that "reduce the administrative burdens and cost of compliance for cable systems that have 1,000 or fewer subscribers." The "net income" analysis appropriately would shield small unprofitable systems in the first stages from the considerable administrative burden of a benchmark analysis or a full-blown cost-of-service analysis. A streamlined cost-of service model for small systems, which has fewer expense categories, also would reduce unnecessary burdens on small systems. Finally, because small system operators maintain their accounting records on a consolidated basis for groups of systems for the purposes of efficiency, it would be an unnecessary burden for small systems to have to allocate costs and revenues to derive figures for a franchise-level or system-level cost-of-service showing.

VII. Conclusion.

Contrary to the arguments proffered by the Telco Commenters, Congress never intended that the cable and telephone industry would be subject to the exact same regulatory standards or that price caps would take the place of cost-of-service. The Commission recognized in its NPRM, that cable operators need access to cost-of-service proceedings so that they can show that, although their rates may be in excess of the relevant benchmarks, they are reasonable in light of the particular operator's circumstances. To comply with Congress' mandate and to satisfy Constitutional requirements, any cost-of-service standards must enable cable operators to recover the reasonable and prudent investment they make in their system.

The question becomes what is fair. It is only fair -- not to mention Constitutionally mandated -- that cable operators be permitted to ultimately recover all of their reasonable and prudent investment. To achieve this fairness for cable operators entering rate regulation we urge the Commission adopt cost-of-service standards that will allow cable operators, who built or rebuilt their systems, to include in their rate base (1) the depreciated original cost of their plant and equipment, (2) all deferred (unrecovered) expenses during the start-up phase, (3) all deferred (unrecovered) interest payments on borrowed funds to meet these costs, (4) all deferred (unrecovered) depreciation, and (5) all budgeted capital expenditures for the ensuing twelve months. We also urge the Commission to adopt cost-of-service standards that will allow cable operators who acquired their systems following construction to justify their rates, as a transitional matter, by including in their rate base the full acquisition cost of their cable system depreciated and amortized to the present date. Finally, we urge the Commission to allow cable operators to allow in their rate bases, at an absolute minimum, to justify current rates or rate increases, (1) that portion of the acquisition cost that represents the full (reproduction) cost of building their system (less depreciation reflecting the system's age) plus all of the deferred and unrecovered start-up expenses the cable operator would incur in achieving a positive net income, and (2) that portion of the acquisition cost associated with saved expenses resulting from operating efficiencies.

Respectfully submitted,

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